"Public Policy Issues Raised By The Report of The Lehman Bankruptcy Examiner"

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FOR IMMEDIATE RELEASE

(Washington, DC) – Today, Rep. Luis V. Gutierrez, Chair of the Subcommittee on Financial Institutions and Consumer Credit, made the following statement at a hearing of the House Financial Services Committee entitled, “Public Policy Issues Raised By The Report of The Lehman Bankruptcy Examiner."

Mr. Chairman, thank you for holding this hearing. With the release of the examiner's report this past month I am glad to see the committee taking up the case of the Lehman failure and its subsequent significant effects on the world financial markets.

The failure of Lehman Brothers was caused by numerous noteworthy factors, all of which combined led to the largest corporate bankruptcy in U.S. history. Lehman’s overexposure to subprime residential mortgage-backed securities, some of which were originated by its own subsidiaries, BNC Mortgage and Aurora, created a situation where the firm's real losses were hiding behind opaque contracts and led to what can only be described as a bank run. Lehman’s failure was also brought about by over-leveraging that was significantly hidden through an investment vehicle called Repo 105. This involved the firm parking its highly leveraged assets to deceptively and artificially lower its net leverage right before its regular quarterly reports. Another significant factor was a dramatic misalignment in the compensation structure of the firm whereby they allowed for millions of dollars to be awarded as compensation for short term profits with little or no regard to the investments value or sustainability beyond the short term.

The failure of Lehman Brothers, while causing the loss of billions of dollars of real world wealth for investors great and small throughout the world, can also be a cautionary tale about how to move forward. This failure represents perhaps one of the best justifications for the financial services regulatory reform package that the House passed in December and the Senate is currently considering. I firmly believe that if this legislation had been enacted in the years prior to 2008, Lehman may have survived and its failure may have not caused systemic risk. In short, we would not have faced the crisis that we did in 2008.

The Consumer Financial Protection Agency, as created under the House legislation (H.R. 4173, the Wall Street Reform and Consumer Protection Act), would have prevented the origination of many of the underlying mortgages of the mortgage-backed securities that brought down Lehman. Strong consumer protections would have eliminated the threat to the financial system that was created by the rising defaults on subprime mortgages. Language contained in the Wall Street Reform and Consumer Protection Act would have required all derivatives to pass through an exchange thus allowing their underlying contents to be examined publicly and requiring adequate capital to be set aside in case of their failure, much as insurance companies are currently required to do.

Ultimately, one of the main reasons the financial system froze up after the failure of Lehman Brothers was the lack of certainty regarding the firm’s bankruptcy filing. Because no one understood who would lose what in the days following Lehman’s failure, corporate credit markets dried up and caused a financial crisis not seen in this country for more than 70 years.

The legislation passed by the House requires not only that firms maintain a “living will” that would answer many of the questions left unanswered during the Lehman failure, but creates a resolution process for “too big to fail” institutions. A key component of this resolution process is an amendment that I introduced in the House language that creates a dissolution fund, paid for by the riskiest institutions, which would cover any short-term costs associated with the dismantling of a failed systemically significant financial institution if it could not otherwise be resolved under bankruptcy proceedings.

If one lesson is to be taken away from the failure of Lehman Brothers, it is that we need a strong resolution authority to clean up failed financial institutions that pose a systemic threat to our economy. The dissolution fund, combined with the resolution authority created by H.R. 4173, is the keystone in the system to prevent another failure like Lehman Brothers from threatening the livelihoods of everyday Americans ever again.

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